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In the Supreme Court of the United States

OCTOBER TERM, 1980

VICTOR P. DIEDRICH AND
FRANCES T. DIEDRICH, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

UNITED MISSOURI BANK OF KANSAS CITY, N.A.,
EXECUTOR OF THE ESTATE OF FRANCES D. GRANT,
DECEASED, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT

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The question presented by the petitions in these federal income tax cases is whether, as a result of petitioners'[1] transfers of appreciated property subject to the condition that the donees pay the resulting federal and state gift taxes,

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[1]As used in this Memorandum, the term "petitioner" refers to the decedent rather than the executor in *United Missouri Bank*, when the context so indicates.

they realized income (taxable as capital gain) to the extent the gift taxes the donees paid exceeded petitioners' bases in the transferred property.

In both of these cases, petitioners made a gift of low basis, highly appreciated securities to a member of their family.[2] As a condition of the gift, the donees agreed to pay the donors' federal and state gift taxes incurred as a result of the gift. The gift taxes paid by the donees in each instance exceeded petitioners' bases in the securities transferred (Pet. App. A3).

On audit, the Commissioner determined that petitioners realized taxable gain on the transfers to the extent that the gift taxes paid exceeded petitioners' adjusted bases in the property transferred. The Tax Court, however, rejected the Commissioner's analysis. Following *Turner* v. *Commissioner*, 410 F. 2d 752 (6th Cir. 1969), aff'g per curiam 49 T.C. 356 (1968), and *Hirst* v. *Commissioner*, 572 F. 2d 427 (4th Cir. 1978) (en banc), the Tax Court held that the donor of property in such a case does not realize taxable income on the donee's payment of the gift tax (Pet. App. A12-A22). See *Estate of Henry* v. *Commissioner*, 69 T.C. 665 (1978), appeal pending, No. 78-1340 (6th Cir.).

The court of appeals reversed (Pet. App. A1-A11). It concluded that *Turner* and *Hirst* were incorrectly decided and that "to the extent the gift taxes paid by donees exceeded donor's adjusted bases in the property transferred, the donors realized taxable income" (Pet. App.

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[2]Petitioners' basis in the stock transferred in *Diedrich* was $51,073. The fair market value of the securities, as reported in their 1972 return, was $398,369 (Pet. App. A18-A20). In *United Missouri Bank*, the decedent's basis in the 90,000 shares of stock transferred to her son was $8,742.60 (Pet. App. A14-A15). Although the Tax Court did not determine the fair market value of this stock at the time of the gift, the substantial gift tax paid in 1971 ($232,630.09) indicates that the stock's value exceeded $1,000,000. See 26 U.S.C. (1970 ed.) 2502.

A11). In so holding, the court of appeals cited with approval *Johnson* v. *Commissioner*, 495 F. 2d 1079 (6th Cir.), cert. denied, 419 U.S. 1040 (1974), and *Estate of Levine* v. *Commissioner*, 634 F. 2d 12 (2d Cir. 1980), in which donors of property encumbered by nonrecourse indebtedness were held taxable on the transfers to the extent the indebtedness exceeded their bases in the property. As the court stated, "[i]t makes no difference whether he [the donor] receives the benefit in the form of relief of encumbrance, or in the form of relief of tax liability; in either case, the determinative factor is the receipt of the benefit" (Pet. App. A10).

DISCUSSION

1. Section 61(a) of the Internal Revenue Code of 1954 (26 U.S.C.) provides that gross income means all income from whatever source derived. Section 1001(a) of the Code provides in particular that the gain from a sale or other disposition of property is the excess of the amount realized therefrom over the transferor's adjusted basis in the property. The amount realized is defined in Section 1001(b) of the Code as the sum of any money received plus the fair market value of any other property received.

It is well established that the amount realized under Section 1001 does not mean that the taxpayer must receive cash (or property) in hand. Rather, the concept of amount realized encompasses a measurable economic benefit in any of many forms, including a discharge of personal liability. Thus, in *Old Colony Trust Co.* v. *Commissioner*, 279 U.S. 716 (1929), this Court held that payment of a taxpayer's federal income tax liability by another person is tantamount to actual payment of that amount to the taxpayer and use by him of that money to pay his taxes. Similarly, the discharge of indebtedness on the transfer of property constitutes the receipt of income for purposes of Section 61(a). *Crane* v. *Commissioner*, 331 U.S. 1, 13-14 (1947).

In accordance with these principles, the court of appeals correctly held that petitioners were taxable on their net gift transfers to the extent that the gift taxes paid exceeded their adjusted bases in the property transferred. By making the gifts conditional on the donees' payment of the applicable gift taxes, petitioners have received a real and substantial economic benefit, because the donee's payment discharged petitioners from their primary liability for the payment of gift taxes on the transfers. See Sections 2502(d) and 6324(b) of the Code. As the court below observed (Pet. App. A10), the making of a net gift is tantamount to the donee's having paid money directly to the donor for the latter's use in paying his gift tax liability. From an economic standpoint, a net gift transfer is equivalent to the donor's sale of a portion of his property for cash in an amount equal to the gift tax liabilities, and thereafter donating the remainder of the property to the intended recipients. Since the donor would clearly be liable for the payment of income tax in that case, assuming the amount realized by the sale exceeded his basis (cf. Treasury Regulations on Income Tax, Section 1.1001-1(c) (26 C.F.R.)),[3] there is no reason for excusing him from income tax on a net gift transfer merely because a different route leading to the same destination is followed. As this Court admonished in *Minnesota Tea Co.* v. *Helvering*, 302 U.S. 609, 613 (1938), "[a] given result at the end of a straight path is not made a different result because reached by following a devious path."

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[3]Although this type of transaction has been referred to as a "part gift, part sale" (see, *e.g.*, *Turner* v. *Commissioner*, *supra*), that descriptive phrase lacks substantive content. It is used merely to illustrate situations in which the transferor has disposed of property (by gift, sale, or some other means) for a consideration less than its fair market value. But cf. *Evangelista* v. *Commissioner*, 629 F. 2d 1218, 1221 (7th Cir. 1980).

Thus, in *Johnson* v. *Commissioner, supra,* the court imposed an income tax upon the donor of low basis, highly appreciated stock where, immediately prior to the gift, the donor had pledged the stock as collateral for a loan, the proceeds of which were used in large part to satisfy the donor's gift tax liability on the transfer. Describing the interrelated series of transactions there as equivalent to the donee's payment of the donor's gift tax liability, the court of appeals stated that "[t]he payment of a donor's gift tax liability by the donee constitutes income to the donor" (495 F. 2d at 1083). The Second Circuit reached a similar conclusion in *Estate of Levine* v. *Commissioner, supra,* where the donor of property encumbered by nonrecourse mortgages in excess of his adjusted basis was held taxable on that excess. Expressing agreement with the decision in *Johnson,* which it viewed as effectively overruling *Turner* as a precedent (634 F. 2d at 17), the court in *Levine* declined to follow *Hirst* and stated that "the assumption of another's legal obligation or debt is considered income" (*id.* at 16).

2. While we believe that the court of appeals correctly held that a donor in a net gift situation realizes taxable income to the extent that the amount of gift taxes paid by the donee exceeds the donor's adjusted basis in the property transferred, we agree with petitioner (Pet. 8-12) that the decision below conflicts with that of the Fourth Circuit in *Hirst* v. *Commissioner, supra,* and with those of the Sixth Circuit in *Turner* v. *Commissioner, supra,* and *Owen* v. *Commissioner,* 81-2 U.S.T.C. para. 9509 (June 23, 1981), petition for rehearing with suggestion of rehearing en banc pending, No. 78-1341 (6th Cir.). [4] The Internal Revenue

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[4] In *Owen,* a divided panel of the court of appeals held that it would follow *Turner* in a net gift situation on stare decisis grounds. Although two members of the panel regarded *Turner* as incorrectly decided, the court was unwilling to depart from the rule of law announced in *Turner*

Service advises that there are at least 22 other cases involving approximately $4.5 million in income taxes pending administratively or in the lower courts, and presenting the same issue under consideration here.[5] Accordingly, we do not oppose the granting of the petition for a writ of certiorari.

CONCLUSION

The petition for a writ of certiorari should be granted.

REX E. LEE
Solicitor General

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unless that case was overruled by the full court of appeals or unless this Court held to the contrary.

In *Evangelista* v. *Commissioner, supra,* 629 F. 2d at 1222-1224, the court of appeals analyzed, but expressly declined to decide (compare Pet. 9), the issue whether a net gift can result in income to the donor. The position of the Fifth Circuit on this issue is unclear. Compare *Estate of Davis* v. *Commissioner,* 469 F. 2d 694 (5th Cir. 1972), aff'g per curiam 30 T.C.M. 1363 (1971), with *Malone* v. *United States,* 455 F. 2d 502 (5th Cir. 1972), aff'g per curiam 326 F. Supp. 106 (N.D. Miss. 1971).

[5]There are nine such cases pending in the courts of appeals: *Owen* v. *Commissioner, supra; Estate of Henry* v. *Commissioner, supra; Benson* v. *Commissioner,* 37 T.C.M. 989 (1978), appeal pending, No. 79-1032 (6th Cir.); *Bradford* v. *Commissioner,* 70 T.C. 584 (1978), appeal pending, No. 79-1094 (6th Cir.); *Davis* v. *Commissioner,* 74 T.C. 881 (1980), appeal pending, No. 81-1187 (6th Cir.); *Estate of Currey* v. *Commissioner,* 41 T.C.M. 800 (1981), appeal pending, No. 81-1423 (6th Cir.); *Estate of Warren* v. *United States,* 47 A.F.T.R.2d 1457 (Mar. 24, 1981), appeal pending, No. 81-1462 (8th Cir.); *Estate of Weeden* v. *Commissioner,* 39 T.C.M. 699 (1979), appeal pending, No. 80-7127 (9th Cir.); *McNiece* v. *Commissioner,* 41 T.C.M. 969 (1981), appeal pending, No. 81-7341 (9th Cir.).